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How to Responsibly Leave an Inheritance to Your Grandchildren

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As an estate planning attorney, I am frequently asked, "I'd like to leave something to my grandchildren. What's the best way to do that?"

Naturally, grandparents love their grandchildren and want them to succeed in life. And when grandparents are in the twilight of their lives, their hearts often turn to the younger generation with a desire to give them whatever advantages they can, especially if they were unable to give their own children those same advantages when their children were younger.

For most grandparents, the best way to provide for their grandchildren is to leave their accounts and property to the grandchildren's parents to ensure the financial stability of that family unit, thereby indirectly benefiting the grandchildren. In fact, default inheritance laws in nearly every state reflect this common desire to provide first for children and then for the grandchildren in the event that an adult child predeceases the grandparent. From a practical perspective, the grandchildren's parents are often in the best position to know how to use the money for the benefit of their children and can spend or invest it appropriately on their behalf.

In some cases, however, it makes better sense for grandparents to leave property to their grandchildren—for example, if the grandparents have reason to believe that their own children would not responsibly use the money intended for the benefit of the grandchildren, or if the grandchildren's parents are independently wealthy and distributing the property to them would unnecessarily expose the property to estate tax in their own children's estates. In some cases, although the intent of grandparents may have been to leave everything to their adult children, an inheritance may flow to grandchildren unintentionally because of an accident or illness that prematurely takes the life of an adult child. In any of these situations, it is important to consider the possibilities and the options for leaving an inheritance to grandchildren. Failing to do so can have long-lasting consequences and, in many cases, do more harm than good.

The Trouble with Outright Gifts

Perhaps the simplest way to leave an inheritance to your grandchildren is to name them as beneficiaries in your will or trust to receive a specific amount of money or a percentage of your total accounts and property. If all of the grandchildren who will receive such gifts are physically and emotionally stable, financially prudent, and have reached adulthood, this strategy may work just fine and reduce the administrative burden of managing and distributing your accounts and property to the beneficiaries or heirs.

However, depending on when you pass away, if any of the named grandchildren are minors, you could create additional hassles by leaving a gift directly to them. The executor of your estate or the trustee of your trust may have to establish certain types of custodial accounts to hold that gift for the minor child until they have reached the age of majority. In some states, and depending upon how much money is involved, establishing a court-controlled conservatorship over the property may be required. In other cases, setting up an account using the Uniform Transfers to Minors Act laws of the state may be all that is necessary. In either of these cases, however, once the child reaches the age of majority, you may not be able to control how that money is used by the grandchild. It could be spent on fast cars and fancy clothes rather than on an education, starting a business, or a down payment on a home as you might have imagined. In a worst-case scenario, a grandchild might even unwisely invest it with a spouse who later divorces them, or with an unscrupulous business partner who preys upon inexperienced individuals who have come into a sum of money.

By being aware of these risks, you can take steps today to make sure that any of your property that ends up in the hands of your grandchildren is protected from not only your grandchildren's own poor spending choices but also the claims of a divorcing spouse, an unethical business partner, or an opportunistic lawsuit filed by a stranger against your grandchild.

Generation-Skipping Transfer Taxes

You should seek advice from your attorney or accountant with regard to potential taxation of gifts to grandchildren because Generation-Skipping Transfer ("GST") taxes could be at play. For most people with modest accounts and property, the GST tax is not a significant issue. However, if what you own is valued at more than the current estate tax exemption amount, the GST tax is something that you should be aware of and plan around, particularly if you anticipate that any amount of your property will eventually be distributed to your grandchildren. You should also be aware of the GST tax if you are creating trusts specifically for your grandchildren and their descendants. You may need to take certain steps upon creation of such trusts to ensure that the trust is GST tax-exempt. Your tax professional can provide you with important guidance on this point.

Using Trusts for Gifting to Grandchildren

A trust offers one of the most flexible methods for leaving an inheritance to grandchildren. When you leave an inheritance to grandchildren via a trust, you can ensure that the money and property are used appropriately and at appropriate times. There are a variety of ways to use trusts in your estate planning. You can add provisions to your will or revocable living trust that instruct the trustee to hold any property that is payable to a grandchild in a separate trust share rather than making a direct distribution of the accounts or property to them. You can specify in those trust terms how the money is to be used or distributed and when. These can be very important provisions to include in your trust even if you are planning to leave your accounts and property only to your children. As mentioned, it is possible for your child to pass away before you do in an accident or from illness. And if your child has children of their own and you want your child's share to go to their children, it can be crucial to have a trustee protect and manage it until it can be distributed to the grandchildren at a more appropriate time.

Another way to use trusts is to create the trust during your lifetime, name yourself as the trustee, and transfer some of your property into the trust for the benefit of your grandchildren. From a tax perspective, you can make gifts to this trust using the annual gift tax exemption (currently, $15,000 per beneficiary of the trust per year) to shelter the gifts from transfer taxes. Gifting in this way during life allows you to have confidence that the trust is set up appropriately and enables you to enjoy watching your grandchildren actually benefit from the trust. You can also feel confident that once you pass away, your grandchildren and even your great-grandchildren will continue to benefit from the property in the trust, if that is your goal.

Health and Education Exclusion Trusts

Beyond the traditional use of trusts in your estate planning, you can also design special trusts to provide additional tax benefits if your estate is large enough to potentially be subject to the generation-skipping transfer (GST) tax. A health and education exclusion trust (HEET) is one of these special types of trusts. A HEET is designed to make use of certain tax code provisions that exclude from lifetime gifts any amounts paid directly to healthcare and education institutions on behalf of someone. A HEET can be designed to name, as beneficiaries, any number of your grandchildren or succeeding generations, if desired. The funds in the trust can then be used to pay for health and education expenses directly on behalf of the beneficiaries without being subjected to gift taxes in the future. Furthermore, the distributions to the beneficiaries will be exempt from the GST tax. This benefit is obtained by naming a charitable institution as an additional beneficiary of the trust. As long as the trustee makes regular and reasonably substantial distributions to the charitable beneficiary from the trust, the distributions to the other beneficiaries will be GST tax-exempt.

A HEET is worth considering if (1) you would like to help your grandchildren and succeeding generations with their education and medical expenses, (2) you have used up your GST tax exemption amount through gifting or other estate planning strategies, and (3) you want to benefit a charitable organization as part of your estate planning.

Keeping Parents in the Loop

Grandparents often overlook bringing parents into the conversation when planning for their grandchildren. Consequently, some grandparents have been unpleasantly surprised at the negative reactions from their own children or in-laws when they make generous gifts to their grandchildren. Depending on a family's parenting philosophy, the grandchildren's parents may resent an unexpected, large sum of money or payment for certain expenses. Instead of seeing it as a boon, a parent could see it as a grandparent interfering in the character development of their children, robbing them of important opportunities to become financially independent, learn important life lessons about sacrifice and hard work, such as qualifying for merit-based scholarships, and the value of money in general. Speaking beforehand with your grandchildren's parents about how you can best support the development of your grandchildren into responsible adults can go a long way toward ensuring that your gifts will be appreciated and truly beneficial.

Conclusion

Whether you want to specifically and intentionally include your grandchildren in your estate planning or just want to make sure that they are carefully accounted for in the event that they unexpectedly inherit your property, it is critical to examine your estate planning with your attorney to make sure that your plan reflects your wishes and your family's values. Beyond making sure your property gets to the right people at the right time, careful planning with the help of your tax professionals can also ensure that significant tax savings are preserved, thereby keeping more money in the hands of your family and out of the hands of the government. Want to learn more? Get started by scheduling a time with one of our estate planning attorneys today.